

GULF OIL EXPLORATION AND PRODUCTION CO.

IBLA 85-59

Decided December 4, 1986

Appeal from a decision of the New Mexico State Office, Bureau of Land Management, affirming decisions of the Associate District Manager, Tulsa District Office, providing for the assessment of compensatory royalty on Indian oil and gas leases NM-45437-A and NM-45437-B.

Affirmed in part, vacated in part and remanded.

1. Oil and Gas Leases: Compensatory Royalty--Oil and Gas Leases: Drainage

BLM may properly provide for the assessment of compensatory royalty pursuant to 43 CFR 3162.2(a) where an oil and gas lessee fails to drill a well to protect the lessor from loss of royalty due to drainage, and the lessee has failed to demonstrate that the quantity of oil or gas underlying the lease which would be lost by drainage is not sufficient to pay the cost of drilling and operating the well at a reasonable profit.

2. Oil and Gas Leases: Compensatory Royalty--Oil and Gas Leases: Drainage

When the record supports a conclusion that drainage is occurring, but also indicates BLM's intent to have a lessee pay compensatory royalties, regardless of whether or not a paying productive well can be drilled, the decision will be vacated and the case remanded to BLM to provide appellant an opportunity to submit evidence that a prudent operator would not drill a protective well.

APPEARANCES: N. E. Turnbo, Production Manager, Gulf Oil Exploration and Production Company, Oklahoma City, Oklahoma, for appellant; Cecelia Ann Duncan, Esq., Office of the Field Solicitor, U.S. Department of the Interior, Santa Fe, New Mexico, for the Bureau of Land Management.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

The Gulf Oil Exploration and Production Company has appealed from a decision of the New Mexico State Office, Bureau of Land Management (BLM), dated September 14, 1984, affirming decisions of the Associate District

Manager, Tulsa District Office, dated August 21 and 22, 1984, assessing compensatory royalty for Indian oil and gas leases NM-45437-A and NM-45437-B. Appellant has appealed only the decision to assess compensatory royalty for Indian oil and gas lease NM-45437-A. 1/

By certified letter dated October 20, 1983, the Associate District Manager, Tulsa District Office, notified appellant that the NE 1/4 SE 1/4 SW 1/4 sec. 12, T. 5 N., R. 7 E., Indian Meridian, Seminole County, Oklahoma, within Indian oil and gas lease NM-45437-A, was "subject to drainage" by well No. 13-Cheparney situated in the NW 1/4 SE 1/4 SW 1/4 sec. 12, T. 5 N., R. 7 E., Indian Meridian, Seminole County, Oklahoma, which had been completed on September 29, 1975, "in the McLish formation, with an initial potential of 230 BOPD [barrels of oil per day]." The Associate District Manager stated that appellant "will be expected to drill a protective well on your leasehold" unless it could demonstrate there was little or no chance of encountering sufficient oil or gas to pay the cost of drilling and operating the well at a reasonable profit. The Associate District Manager also stated that appellant would be required to pay compensatory royalty "unless you can demonstrate that geologic conditions at depth prevent any oil and/or gas beneath the Indian leasehold being produced from the offsetting well."

Appellant responded by letter dated November 15, 1983, stating that well No. 2-Cheparney, situated in the NE 1/4 SE 1/4 SW 1/4 sec. 12, T. 5 N., R. 7 E., Indian Meridian, Seminole County, Oklahoma, had tested water in the Wilcox formation at 4,420 feet and was completed in the Hunton formation in July 1936 "when the deeper zones were found to be non-productive." The Acting Associate District Manager responded in a December 7, 1983, letter that well No. 2-Cheparney 2/ had not tested the McLish formation and that various other offsetting wells had or were producing from various formations, including the McLish.

In a letter dated January 12, 1984, appellant stated that well No. 14-Cheparney, situated in the SE 1/4 SE 1/4 SW 1/4 sec. 12, T. 5 N., R. 7 E., Indian Meridian, Seminole County, Oklahoma, had been drilled to the McLish formation and "completed as a dry hole." Appellant also noted that

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1/ Appellant's notice of appeal was filed with respect to the entire September 1984 BLM decision. However, appellant's statement of reasons for its appeal makes no reference to the requirement to pay compensatory royalty with respect to Indian oil and gas lease NM-45437-B. Accordingly, we will not consider that portion of the September 1984 BLM decision. The decision as to that lease is final.

2/ BLM referred to well No. 12-Cheparney. However, it is apparent BLM meant well No. 2-Cheparney, situated in the NE 1/4 SE 1/4 SW 1/4 sec. 12. The well is designated as the No. 2-Cheparney on a structure map for the Viola formation prepared by appellant, and will hereafter be given that designation.

well No. 2-Cheparney 3/ is "low to the Cheparney #14 which was drilled through the McLish formation." By letter dated April 4, 1984, the Acting Associate District Manager informed appellant BLM had concluded "the only formation at the present time that appears to need protection from drainage on [Indian oil and gas lease NM-45437-A] is the McLish formation."

In a decision dated August 22, 1984, the Associate District Manager stated appellant would be assessed compensatory royalty based on production from well No. 13-Cheparney, because appellant had failed to demonstrate that geologic conditions at depth prevented any oil and/or gas beneath Indian oil and gas lease NM-45437-A from being produced from that well. 4/

By letter dated August 30, 1984, appellant requested a technical and procedural review of the August 1984 decision of the Associate District Manager, pursuant to 43 CFR 3165.3. Appellant reiterated that well No. 14-Cheparney had been completed as a dry hole and there is "no geological information" to indicate the NE 1/4 SE 1/4 SW 1/4 sec. 12 is "structurally higher than the Cheparney #14." In its September 1984 decision, BLM concurred in the August 1984 decision of the Associate District Manager providing for the assessment of compensatory royalty for Indian oil and gas lease NM-45437-A. BLM stated that a structure map submitted by appellant showed the Viola formation was "as much as fifty feet higher" at well No. 2-Cheparney 5/ than at well No. 14-Cheparney and there is no evidence the "structural trend of the McLish [formation] is not similar." 6/ BLM concluded that compensatory royalty would be assessed "from the date of first production of the offending well."

In its statement of reasons for appeal, appellant contends it is not required to pay compensatory royalty because there are "no producible hydrocarbons" in the McLish formation underlying the E 1/2 SE 1/4 SW 1/4 sec. 12, T. 5 N., R. 7 E., Indian Meridian, Seminole County, Oklahoma, and, thus, no drainage can occur. Appellant submits a stratigraphic cross-section running

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3/ Appellant actually referred to well No. 6-Cheparney. However, it is apparent that appellant meant well No. 2-Cheparney, situated in the NE 1/4 SE 1/4 SW 1/4 sec. 12.

4/ The Associate District Manager stated compensatory royalty would be assessed from Sept. 29, 1975, the date completion of well No. 13-Cheparney became public knowledge, until the last date of production from that well, the effective date of relinquishment of the affected portion of the lease, or the date of commencement of continuous production from a protective well.

5/ BLM actually referred to well No. 6-Cheparney. We presume BLM meant well No. 2-Cheparney. See note 3.

6/ In a Dec. 5, 1984, memorandum attached to BLM's reply brief (Exh. A), Mark Milliken, Branch of Fluids, New Mexico State Office, stated that "[a]ssuming that there are no drastic changes in bed thicknesses, it can be assumed that the McLish structure is similar to that of the Viola."

from well No. 4-Milo Reed to well No. 3-Harjo 7/ in an east-west line across the NE 1/4 SE 1/4 SW 1/4 sec. 12, along with structure and net-pay isopach maps of the area. This evidence purportedly indicates the oil/water contact in the McLish formation is west and upslope of the NE 1/4 SE 1/4 SW 1/4 sec. 12. Appellant also submits a "drainage calculation" for well No. 13-Cheparney, i.e., the "offending well," which, using figures for cumulative oil production, the net-pay thickness and oil in place, results in a drainage area of 9.2 acres, which would not include the NE 1/4 SE 1/4 SW 1/4 sec. 12.

In a reply to appellant's statement of reasons, BLM contends it properly provided for the assessment of compensatory royalty, relying on a December 5, 1984, evaluation of the evidence submitted by appellant on appeal by Mark Milliken, Branch of Fluids, New Mexico State Office (Exh. A). Milliken states he had originally determined the drainage area for well No. 13-Cheparney based on reservoir data supplied by appellant on September 5, 1984. The resulting area was 110 acres. Milliken further states that calculations, using the different figures submitted by appellant on appeal, results in a drainage area of 60 acres, which "reaffirm[s] the contention that drainage is occurring." Milliken also disputes the structure map submitted by appellant on appeal which shows the McLish formation to be lower at well No. 2-Cheparney than at well No. 14-Cheparney. Milliken states the map is an unexplained "departure" from the Viola formation structure map previously submitted. Milliken also questions the manner in which the oil/water contact in the McLish formation shown on appellant's structure map was derived, especially given the fact the McLish formation was not penetrated in the two wells on the eastern end of the stratigraphic cross-section submitted by appellant. 8/

[1] The applicable regulation, 43 CFR 3162.2(a), provides, in relevant part, that in the case of oil and gas leases:

The lessee shall drill diligently and produce continuously from such wells as are necessary to protect the lessor from loss of royalty by reason of drainage. The authorized officer may assess compensatory royalty under which the lessee will pay a sum determined as adequate to compensate the lessor for lessee's failure to drill and produce wells required to protect the lessor from loss through drainage by wells on adjacent lands.

Thus, the regulation essentially requires a lessee to drill a protective well in cases of drainage and provides that, if the lessee fails to do so,

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7/ The two intervening wells are well No. 13-Cheparney and well No. 2-Cheparney (referred to as well No. 6-Cheparney).

8/ The cross-section purports to show that the McLish formation is lower in well Nos. 2-Cheparney and 3-Harjo, although no electric log was run below the Hunton formation in well No. 2-Cheparney and no log was run in well No. 3-Harjo.

the authorized officer may assess compensatory royalty. However, each provision is subject to a specific limitation. A protective well is required only where it is necessary "to protect the lessor from loss of royalty by reason of drainage." Id.

It is well established a lessor is to be protected from loss of royalty by reason of drainage only in those circumstances where the quantity of oil or gas which underlies the lease and would be lost by reason of drainage is "sufficient \* \* \* to pay a reasonable profit to the lessee over and above the cost of drilling and operating the well." Nola Grace Ptasynski, 63 IBLA 240, 247, 89 I.D. 208, 212 (1982) (quoting from Olsen v. Sinclair Oil & Gas Co., 212 F. Supp. 332, 333 (D. Wyo. 1963)). As we said in Ptasynski, the reasoning behind this so-called "prudent operator rule" is that, in real terms, there is no loss of royalty by reason of drainage if it is shown to be economically imprudent to drill a protective well to recover the oil or gas. Moreover, as noted in Ptasynski, if such circumstances exist, a lessee will similarly not be required to pay compensatory royalty in lieu of drilling a protective well. However, in Ptasynski we were applying an earlier version of the applicable regulation, 30 CFR 221.21(c) (1979), which provided:

The lessee shall drill diligently and produce continuously from such wells as are necessary to protect the lessor from loss of royalty by reason of drainage, or, in lieu thereof, with the consent of the supervisor, he must pay a sum estimated to reimburse the lessor for such loss of royalty, the sum to be computed monthly by the supervisor. [Emphasis added.]

Under this earlier version of the regulation, the lessee was required to reimburse the lessor for the "loss of royalty" occasioned by the failure to drill a protective well. As we stated in Nola Grace Ptasynski, supra at 251, 89 I.D. at 214-15, where it is not prudent to drill a protective well to recover the oil or gas underlying a lease there is simply no "loss of royalty" requiring compensation to the lessor:

[W]hile in some conceptual sense the landowner has lost the oil drained, there has been no economic loss occasioned by the drainage. The landowner is no worse off than he was before the offending well commenced to drain his meager reserves, and considerably better off than he would be if he tried to recover them by drilling an offset well. [Footnote omitted.]

Thus, we concluded that "where the evidence establishes that a prudent operator would not drill an offset well to protect against drainage [resulting in a loss of royalty] there is no requirement that the lessee \* \* \* either drill the offset well or tender compensatory royalty." Id. at 252, 89 I.D. at 215 (emphasis added).

The current version of the regulation does not provide that compensatory royalty will be paid to reimburse the lessor for the loss of royalty. Rather, it provides that compensatory royalty will be paid to compensate the lessor for the lessee's failure to drill a well "required to protect the

lessor from loss through drainage." 43 CFR 3162.2(a). In his October 1983 letters to appellant, the Associate District Manager stated that:

[Gulf] will be expected to drill a protective well \* \* \* unless [Gulf] can demonstrate with detailed \* \* \* data that such a well would have little or no chance of encountering oil or gas in reasonable quantities sufficient to pay the cost of the drilling and operating the well with a reasonable profit.

The October 1983 letters further stated compensatory royalty must be paid "[r]egardless of whether or not a paying productive well can be drilled." The only exception to the requirement to pay compensatory royalty recognized in the October 1983 letters was when no drainage was occurring, *i.e.*, where "geologic conditions at depth prevent any oil and/or gas beneath the Indian leasehold being produced from the offsetting well."

On April 4, 1984, BLM responded to information submitted by appellant regarding the geology underlying the tract in question and adjacent parcels and production from nearby wells. In the letter BLM concluded the McLish formation was the only formation "that appears to need protection from drainage on the two Indian leaseholds." BLM restated its request that the two leaseholds be protected from drainage and directed Gulf to either relinquish the undeveloped portion of the leasehold, commence drilling or submit data justifying a failure to drill the well. BLM noted that, in any event, compensatory royalties would be assessed.

On August 22, 1984, BLM issued a decision that compensatory royalties would be assessed for lease NM-45437-A commencing September 29, 1975, the date completion of the offending well became public knowledge. Gulf requested a technical and procedural review of the BLM decision.

A technical and procedural review was conducted and in a September 14, 1984, decision, the Deputy State Director concurred with the August 1984 decision, holding that "[r]egardless of whether or not a paying protective well can be drilled, there is an obligation to pay a compensatory royalty unless geologic conditions are such that there is no drainage" (Decision at 1).

Gulf appealed from the September 1984 decision. The thrust of the evidence submitted and the arguments advanced on appeal by BLM and appellant centers on the question of whether the NE 1/4 SE 1/4 SW 14 sec. 12 is being drained by an adjacent well.

The current regulation provides that compensatory royalty will be paid if the lessee fails to drill a well which is "required to protect the lessor from loss through drainage." 43 CFR 3162.2(a) (emphasis added). If this regulation provided that compensatory royalty would be paid where the lessee failed to drill a well in order to protect the lessor from loss through drainage, there would be no question and we would hold such royalty must be paid in all cases where there is drainage. However, the regulatory provision states a compensatory royalty will be paid where a protective well

is "required," i.e., where a well is "necessary to protect the lessor from loss of royalty by reason of drainage." Id. It can be seen that the import of the current regulation has not changed since the earlier version, i.e., 30 CFR 221.21(c) (1979), which was construed in Ptasynski. Indeed, the preamble to the final rulemaking which promulgated the current regulation (originally codified at 30 CFR 221.22(a)) suggests no significant change in the rule. <sup>9/</sup> See 47 FR 47762 (Oct. 27, 1982). We conclude the Department still regards the prudent operator rule as applying equally to the requirement to drill a protective well or, in the alternative, the requirement to pay compensatory royalty when assessed by the authorized officer. <sup>10/</sup> Such an interpretation is eminently fair to the lessee, as well as the Government. Therefore, we conclude, as we did in Ptasynski, that compensatory royalty, in this case under 43 CFR 3162.2(a), may not be assessed in lieu of drilling a protective well where the evidence establishes that a prudent operator would not drill the well.

BLM and appellant have proceeded in this case on the basis that compensatory royalty will not be assessed only where appellant can demonstrate no drainage is occurring. However, no compensatory royalty would accrue, even if there is drainage, if appellant is able to demonstrate it is not reasonably profitable to drill and operate a protective well, given the quantity of oil or gas underlying the lease which would be drained, but for the well. This "defense" is clearly spelled out in Ptasynski and 43 CFR 3162.2(a). Accordingly, we will review the evidence submitted by appellant, in light of the evaluation by BLM. If appellant has in fact demonstrated there is no oil or gas subject to drainage, compensatory royalty could not be assessed. However, if there is drainage, the question of whether a prudent operator would drill a well must be addressed.

We start first with the drainage calculation for well No. 13-Cheparney, which results in a determination of the acreage surrounding that well subject to drainage. It is apparent both appellant and BLM use essentially the same

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<sup>9/</sup> The preamble states in relevant part:

"[S]everal comments suggested that language be included to provide the lessee an opportunity to submit evidence showing that drainage is not occurring under a specific lease. Language has been included to accomplish this. Suggestions were also made that language be added to specify the economic requirements that apply in determining whether compensatory royalty is assessed. These criteria are considered internal and thus are not appropriate for inclusion in the regulations." 47 FR 47762 (Oct. 27, 1982) (emphasis added). The preamble suggests the economic prerequisites to the assessment of compensatory royalty, set out in Ptasynski, still apply.

<sup>10/</sup> The logic of this reasoning would obviously apply to a case where a well is drilled and capped because the production is not sufficient to pay the operating costs. The area could also be drained from an adjacent well with greater recovery. No royalty would be paid, because the oil and gas under the tract would be insufficient for production. Without production, no royalty would accrue, and the lessor would suffer no loss.

equation to determine the drainage area. The only exception is the figures used by BLM for recoverable reserves. BLM uses a "recovery factor" of 0.2 to determine "ultimate reserves." BLM Reply, Exhibit A at 1. By contrast, appellant's calculation is based on cumulative oil production. Appellant has provided no justification for not taking into account the fact that, according to BLM, well No. 13-Cheparney is not achieving complete recovery of oil reserves from the reservoir underlying that well. In the absence of that justification, we must conclude BLM is correct in its computations of the drainage area based on the actual reservoir and, whether using the figures submitted previously or on appeal by appellant, that the drainage area encompasses the NE 1/4 SE 1/4 SW 1/4 sec. 12. 11/

Appellant also argues the stratigraphic cross-section submitted on appeal demonstrates the oil-bearing McLish formation is lower under the NE 1/4 SE 1/4 SW 1/4 sec. 12 and, thus, below the oil/water contact. However, appellant has not shown the location of the oil/water contact in the McLish formation in any of the wells included in the cross-section. Moreover, the cross-section does not establish that the McLish formation is lower in the subject land than at well No. 13-Cheparney because of the absence of electric logs at that depth.

Finally, appellant argues the McLish formation at well No. 2-Cheparney is lower than at well No. 14-Cheparney, which was completed as a dry hole in the McLish formation. As BLM points out, the structure map for the Viola formation, originally submitted by appellant, shows that formation (which is separated from the McLish by the Wilcox formation) to be higher at well No. 2-Cheparney, whereas the structure map for the McLish formation, submitted on appeal by appellant, shows that formation as lower at well No. 2-Cheparney. Appellant has offered no explanation of this discrepancy, and we can attribute no weight to either map.

Based on all the evidence submitted by appellant, we conclude it has failed to demonstrate there are no oil or gas reserves in the McLish formation underlying the NE 1/4 SE 1/4 SW 1/4 sec. 12, subject to drainage by well No. 13-Cheparney. 12/

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11/ We note, however, that, in computing compensatory royalty in his August 1984 decision, the Associate District Manager concluded the portion of well production from well No. 13-Cheparney attributed to oil and gas lease NM-45437-A was 16.85 percent "based on the lease's contribution to the drainage influence area." That influence area was based on a 20-acre drainage area surrounding well No. 13-Cheparney. That area is considerably less than the 110- and 60-acre drainage areas BLM arrived at using appellant's figures. See BLM Reply, Exh. A.

12/ In his August 1984 decision, the Associate District Manager stated that compensatory royalty would be computed using a restricted mineral interest of 16/21. On appeal, appellant states BLM is "aware" that the actual interest is 15/42.



[2] Having determined that drainage is occurring, the issue of whether a prudent operator would drill a well must be addressed. As noted previously, if a prudent operator would not, Gulf would not be required to pay compensatory royalties.

The record contains no evidence regarding the cost of drilling and operating a well to capture the oil being drained. This Board would ordinarily hold that a failure to submit evidence in support of the contention that a prudent operator would not drill the well would result in a finding that a prudent operator would drill the well. However, the decisions issued by BLM held that a compensatory royalty would be due even though a prudent operator would not drill a well, thus focusing the inquiry on the issue of drainage. Under the circumstances we find it appropriate to remand this matter to BLM to give Gulf an opportunity to submit evidence that a prudent operator would not drill a well, even though drainage is occurring. 13/

In addition, in his August 1984 decision, the Associate District Manager stated that compensatory royalty will be assessed "effective September 29, 1975, the date when completion of the offending well was public knowledge." In its request for a technical and procedural review, appellant objected to this "retroactive" assessment. In its September 1984 decision, BLM stated that compensatory royalty "will be assessed from the date of first production of the offending well." However, in Nola Grace Ptasynski, supra at 258, 89 I.D. at 219, we concluded: "Royalties lost because of a failure to drill an offset well do not commence on the completion of the offending well but rather upon the failure to offset that well in a reasonable time after notice." Thus, in the present case, if, on remand, it is determined that a compensatory royalty should be assessed, the royalty amount should be based upon production from a reasonable time subsequent to the date of receipt by Gulf of the October 20, 1983, certified letter sent to appellant notifying it that the NE 1/4 SE 1/4 SW 1/4 sec. 12 was subject to drainage by well No. 13-Cheparney and requiring the drilling of a protective well.

13/ We note that on Mar. 4, 1985, BLM issued Instruction Memorandum No. 85-289, titled "Implementation of Oil and Gas Manual Section 3160-2, Drainage Protection." Therein, BLM stated:

"Specifically, where an operator cannot demonstrate to our satisfaction that subsurface geologic conditions preclude drainage, no compensatory royalty will be assessed if alternatively, the operator can demonstrate to our satisfaction that there has never been a point in time between the onset of production from the offending well until the present at which it would have been possible to have drilled an economic, protective well." [Emphasis supplied.]

This is consistent with our conclusion that an operator may show either there is no drainage or that a prudent operator would not drill a well. However, we reject the notion set forth therein that an operator must show there "never has been a point in time between the onset of production from the

Pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is affirmed in part, vacated in part and remanded.

R. W. Mullen  
Administrative Judge

We concur:

Wm. Philip Horton  
Chief Administrative Judge

Bruce R. Harris  
Administrative Judge

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fn. 13 (continued).

offending well and the present at which it would have been possible to have drilled on economic, protective well."

The Board is not bound by BLM Instruction Memoranda. Sierra Club, 61 IBLA 329 (1982). Thus, we find the prudent operator test should not be applicable until the lessee is notified by BLM that lands within the leasehold are subject to drainage, in this case receipt by Gulf of BLM's Oct. 20, 1983, notice.

